DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0521
Sales and Use Tax
Tax Period: 2002 - 2004

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ISSUES

I. Sales and Use Tax – Manufacturing Exemption

Authority: IC 6-8.1-5-1(b), IC 6-2.5-2-1, IC 6-2.5-4-1, IC 6-2.5-3-2, IC 6-2.5-5-3(b); 45 IAC 2.2-4-2, 45 IAC 2.2-5-8(a), 45 IAC 2.2-5-8(c), 45 IAC 2.2-5-8(g), 45 IAC 2.2-4-1, 45 IAC 2.2-5-8(d), 45 IAC 15-3-2; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003); Tax Policy Directive #9.

The taxpayer protests the assessment of use tax on certain items of tangible personal property that are claimed to be involved in a production process.

II. Sales and Use Tax – Purchase for Resale Exemption

Authority: IC 6-8.1-5-1(b), IC 6-2.5-5-8; 45 IAC 2.2-8-12(c).

Taxpayer protests the imposition of gross retail tax on goods sold for resale.

III. Tax Administration – Ten Percent Negligence Penalty

Authority: IC 6-8.1-1-10-1; 45 IAC 15-11-2(c).

The taxpayer protested the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer and a related company are Indiana corporations in the business of land-clearing and development. This is the service part of its business. However, taxpayer and its related business also produce logs, firewood, mulch, and woodchips as it is clearing the land. Several years ago, taxpayer and its related business went through a protracted dispute with the Department to determine whether the production part of its enterprise was exempt for sales and use tax under the manufacturing exemption of IC 6-2.5-5-3(b). The audit ultimately determined that taxpayer's use of equipment employed in the production operation was entitled to an exemption.

Subsequent to an audit conducted by the Indiana Department of Revenue ("Department"), an assessment was made, which resulted in additional sales and use taxes being owed, as well as interest and penalty. Taxpayer timely protested the assessment, arguing that the previous audit had determined they were exempt.

I. Sales and Use Tax – Manufacturing Exemption

DISCUSSION

A. Machinery

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

Taxpayer's business is twofold. They primarily operate as a land-clearing provider for developers. During this operation, taxpayer is left with all manner of plant waste to contend with, mostly in the form of trees. This is where the second part of the operation enters the picture. Taxpayer turns the waste into four types of products: logs, firewood, mulch, and wood chips. Taxpayer argues that these two operations are dependent on one another for the company's survival. That is to say, if they could not supplement their coffers by producing these goods, then they would not be able to make a competitive bid to obtain the jobs in the first place. For instance, taxpayer trades its mulch to a large landscaping firm, which then provides trucking to the taxpayer.

It should be noted at this point that since taxpayer is in the business of land-clearing, it would stand to reason that taxpayer's job would not be complete until it cleared all of the trees it cut down, the trunks it uprooted, and so on. Therefore, the equipment used in the production process is serving a dual purpose: it is not only being used in the production of marketable goods, but it is also being used to clear the land. The two parts of the operation are indeed complementary to one another, not only in the sense that the taxpayer suggests, but more importantly in the sense that by turning the waste into a marketable product, they are also clearing the land. In other words, one part of the operation complements the other, and vice versa.

Pursuant to IC 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. IC 6-2.5-4-1 provides that a retail transaction involves the transfer of tangible personal property. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction and sales tax was not paid at the time of purchase. IC 6-2.5-3-2.

45 IAC 2.2-4-2 provides that professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail," and are not subject to gross retail tax. Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:

> (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
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> (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
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> (3) The price charged for tangible personal property is inconsequential (not to exceed 10 percent) compared with the service charge; and
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> (4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.

In order to qualify for the sales tax exemption as a service provider, the taxpayer must meet each of the four individual requirements established within 45 IAC 2.2-4-2.

Taxpayer meets the first three requirements of 45 IAC 2.2-4-2, and under normal circumstances, taxpayer would meet the fourth requirement as well. Taxpayer argues that even though it would normally be required to pay sales tax on its equipment, it is in a very unique situation in that along with being a service provider, it also manufactures tangible personal property for resale. Therefore, taxpayer argues, it qualifies for the manufacturing exemption found at IC 6-2.5-5-3(b). Furthermore, taxpayer argues that all its equipment, replacement parts, oil, fuel, tools used to repair said equipment, and so on are likewise exempt.

Under IC 6-2.5-5-3(b) and 45 IAC 2.2-5-8(a), an exemption from the state gross retail tax is provided for transactions involving manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. 45 IAC 2.2-5-8(c) defines “direct use” as use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(g).

The Department regulations provide the following illustrations for when a piece of machinery is used in both an exempt and a taxable manner:

> (1) A forklift is used exclusively to move work-in-process from a temporary storage area in a plant and to transport it to a production machine for processing. Because the forklift functions as an integral part of the integrated system comprising the production operations, it is exempt.
>
> (2) A forklift is used exclusively to move finished goods from a storage warehouse and to load them on trucks for shipment to customers. The forklift is taxable because it is used outside the integrated production process.
>
> (3) A forklift is regularly used 40 percent of the time for the purpose described in Example (1) and 60 percent of the time for the purpose described in Example (2).

> The taxpayer is entitled to an exemption equal to 40 percent of the gross retail income attributable to the transaction in which the forklift was purchased.

45 IAC 2.2-5-8.

The preceding reference is not applicable, because the time-related nature of the illustration does not fit the present situation. The machinery at the job site is not being used for a certain amount of time on excavating and another amount of time on producing a marketable product, which one can then quantify in terms of percentages. The taxpayer uses the machinery for both purposes *at the same time*. It would therefore not be prudent to use a time-related method of allocation.

Since the taxpayer is clearly using some of the equipment to produce a marketable product that will "constitute a transaction of a retail merchant constituting selling at retail" once it is sold, then that part of the operation would fall within 45 IAC 2.2-4-1. Even though turning the refuse into logs, firewood, mulch, and woodchips, is part of the service, and the two parts of the operation cannot be extricated from one another, the form that the taxpayer has chosen to turn the refuse into is significant. Taxpayer could have used several trailers to haul off the refuse in its initial form. Instead, taxpayer chose to produce a marketable product from the refuse. As such, the items purchased to be used exclusively in the production part of the operation, the part that falls within 45 IAC 2.2-4-1, should be 100 percent exempt under IC 6-2.5-5-3(b).

The production process of making mulch and wood chips begins and ends with the grinder and the chipper, respectively. For the production of logs, it begins with the knuckleboom holding the trees in place while the hydro-ax cuts the limbs off the trees and cuts the trees into logs. For the production of firewood, it begins at the headquarters where the firewood processor starts turning the logs into firewood. It does not begin at the job site, because the taxpayer did not meet its burden of proof in showing that transportation and loading onto the machine was part of the same integrated production process pursuant to IC 6-8.1-5-1(b).

The bulldozers, backhoes, skidders and other equipment used to move raw materials around the job site are also claimed by the taxpayer to be part of the production process. These pieces of equipment are moving raw materials around prior to the beginning of the production process. 45 IAC 2.2-5-8(d) deals with "preproduction" and states in relevant part: "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process…." The regulations concern the exemption of machinery if it is used in an integral and essential manner in the production process. To qualify for exemption, machinery must have an immediate effect on the production of the end product. It can only have an immediate effect if it touches and affects the raw material in such a way as to actually change it. Machinery is exempt only if it is used during the production process, and not before the production process begins or after the production process ends. In the taxpayer's situation, the integrated production process begins at the first machine that has an immediate effect on the product. That first step in the integrated production process would then be when the chipper or grinder turns the debris into chips or mulch.

Taxpayer argues that it has for more than a decade relied on a previous audit that determined that the purchases that went towards the production process were to be exempt from sales and use

tax. The Department has reviewed the audit summary, and has determined that it was incorrectly decided. In addition, the Department is not required to follow rulings beyond six years after it is issued. 45 IAC 15-3-2; *See also* Tax Policy Directive #9. Surely an audit summary, which is of less weight than a ruling, will not be followed longer than a ruling. Furthermore, exemptions are to be strictly construed against the party claiming exemption, and if taxpayer has not met its burden of proof in stating why the audit was wrong and why it is due an exemption, then the exemptions will certainly not be granted. Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003). For all of these reasons, the Department is of the position that taxpayer is only due a partial exemption for what it believes to be the overall production process.

Finding

Taxpayer's protest is sustained in part and denied in part.

B. Replacement Parts

Taxpayer protests the assessment of sales and use tax on an assortment of replacement parts. Taxpayer argues that the replacement parts were purchased for exempt equipment and machinery, and that the replacement parts should likewise be exempt.

45 IAC 2.2-5-12 (h)(2) provides that "replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax."

Taxpayer provided sufficient information to the Department to show that parts purchased from Company A were used to repair the chipper and that parts purchased from Company B and C were used to repair the grinder. These purchases are exempt under the manufacturing exemption IC 6-2.5-5-3(b). However, taxpayer did not document what equipment the remaining replacement parts were used to repair. Therefore, taxpayer did not meet its burden of proof for the remaining parts pursuant to IC 6-8.1-5-1(b). As an aside, it would be in the taxpayer's best interest to keep records pertaining to what parts were used in what machines from now on.

Finding

Taxpayer's protest is sustained as to the parts purchased from Company A, B, and C; the rest of taxpayer's protest concerning replacement parts is denied.

C. Hydraulic Oil, Lubricants, Anti-Freeze

Taxpayer protests the assessed tax on hydraulic fluid (oil), lubricants, and anti-freeze. Taxpayer argues that these products are directly consumed by equipment that is used in the production process.

Pursuant to 45 IAC 2.2-5-12, consumption of tangible personal property in the direct production process means "dissipation or expenditure by combustion, use, or application" of the tangible

personal property in an "essential and integral part of an integrated process which produces tangible personal property."

Taxpayer presented no evidence as to which vehicles or equipment the hydraulic oil, lubricants, anti-freeze, or other oils they purchased went towards. Taxpayer failed to meet its burden of proof, and these purchases are likewise not exempt.

Finding

Taxpayer's protest is denied.

D. Tools

Taxpayer protests the assessment of use tax on tools used to fix machinery and equipment used in the field. Tools and equipment used to install replacement parts are not exempt from sales and use tax. 45 IAC 2.2-5-8(h)(1) addresses the issue of maintenance equipment:

> Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

Because the installation of replacement parts is considered to be a "normal repair and maintenance" function, the tools and equipment used to install replacement parts are not exempt from sales and use tax.

Finding

Taxpayer's protest is denied.

E. Safety Clothing and Equipment

Taxpayer protests the imposition of the gross retail tax on its purchase and use of safety clothing and equipment. Safety clothing and equipment qualifies for the directly used in direct production exemption found at IC 6-2.5-5-3 if it meets the standard set at 45 IAC 2.2-5-8(c)(2), example (F), as follows:

> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt.
>
> > (F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

However, equipment primarily for the workers' comfort and convenience is taxable. 45 IAC 2.2-5-8(c)(4)(B).

Taxpayer argued that safety glasses, gloves, radios, and windshields it purchased were to be used by its workers in the production process so they could participate without injury. The taxpayer sufficiently demonstrated that the gloves, safety glasses, and radios were actually used to protect the workers from injury in the workplace. However, taxpayer was not able to show that its workers used the items exclusively for the production process, and therefore did not meet its burden of proof pursuant to IC 6-8.1-5-1(b).

Taxpayer was not able to demonstrate that it purchased the windshields to protect the workers from injury in the workplace instead of providing for the workers' comfort and convenience. Taxpayer also did not demonstrate in which pieces of equipment the items were installed. Therefore, the taxpayer did not meet its burden of proof, and these items are not exempt from tax.

Finding

Taxpayer's protest is denied.

F. Packaging Materials

Taxpayer protests the auditor's determination that taxpayer's purchases of labels, signs, and staplers are subject to the state gross retail tax. The taxpayer attaches labels and signs to its packages of firewood by staples from its staplers. The taxpayer argues that the labels are packaging material and are tax exempt under the Indiana Code.

The relevant statute is IC 6-2.5-5-9(d), which governs wrapping materials, and states:

> (d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

Also of import is IC 6-2.5-5-6, which explains that transactions involving tangible personal property are exempt from the use tax if the purchaser acquires it for "incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business." This exemption is further explained at 45 IAC 2.2-5-14(e) as follows:

> . . . incorporated as a material or an integral part into tangible personal property for sale means:
>
> > (1) The material must be incorporated into and become a component of the finished product.
> >
> > (2) The material must constitute a material or integral part of the finished product.
> >
> > (3) The tangible property must be produced for sale by the purchaser.

The issue then is whether the labels become a material part of the finished product. The labels may help identify the source of the firewood to the consumer, but the purchase of taxpayer's labels is still not entitled to the manufacturing exemption afforded under IC 6-2.5-5-6. The labels do not "constitute a material or integral part of the finished product," because the labels are not essential to the taxpayer's finished product and because the labels do not affect the performance or utility of that finished product. The labels are merely the ancillary means by which taxpayer's finished product finds its way to the ultimate consumer.

Finding

Taxpayer's protest is denied.

G. Office Supplies

Taxpayer protests the assessment of use tax on supplies purchased for its office. IC 6-2.5-3-2 covers such items as office supplies, including envelopes, dividers, and mechanical pencils. Taxpayer failed to remit use tax on several of these items. There is no manufacturing exemption under 6-3.5-5-3, because they are not a part of the production process. 45 IAC 2.2-5-8(c)(4) goes on to state that "equipment…located in the administrative offices" are not exempt "[b]ecause of the lack of an essential and integral relationship" in the overall production process.

Finding

Taxpayer's protest is denied.

H. Salary

Taxpayer claimed that an item being assessed use tax was actually the salary of one of its summer employees. Whether this was a clerical error on the part of the taxpayer or not is unclear. Normally, the payment of salary is not a gross retail transaction, and thus sales and use tax cannot be assessed. However, taxpayer did not provide any papers proving the item in question was an employee's salary, such as a SSI or W2 form, and thus did not meet its burden of proof.

Finding

Taxpayer's protest is denied.

II. <u>Sales and Use Tax</u> – Purchase for Resale Exemption

Taxpayer also argues that it was incorrectly assessed gross retail tax on firewood and mulch sold for resale, and thus is exempt. The relevant statute for the resale exemption is IC 6-2.5-5-8, which states in relevant part:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or

> leasing in the ordinary course of his business without changing the form of the property.

The tax assessment is presumed to be correct. Taxpayer bears the burden of proving that the assessment is incorrect and the mulch and firewood qualify for the resale exemption. IC 6-8.1-5-1(b). The Department presumes that every intra-state sale of tangible of personal property is subject to sales tax; it is the buyer's and the seller's obligation to establish that the particular transaction is exempt. The simplest way to meet this burden is for the buyer to issue an exemption certificate. 45 IAC 2.2-8-12(c). Since taxpayer presented no exemption certificates from the buyers protested in the audit, and has also not presented any other evidence supporting their contention that the buyers were reselling the mulch or firewood, it has not met its burden of proof.

FINDING

Taxpayer's protest is denied.

III. Tax Administration – Ten Percent Negligence Penalty

DISCUSSION

The department can waive the negligence penalty pursuant to the provisions of 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but re not limited to:
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> (1) the nature of the tax involved;
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> (2) judicial precedents set by Indiana courts;
>
> (3) judicial precedents established in jurisdictions outside Indiana;
>
> (4) published department instructions, information bulletins, letter of findings, rulings, letters of advice, etc.'
>
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided substantial documentation indicating that it based its business practices on a previous audit. After the previous audit, the taxpayer changed its use tax reporting to comply with the law. The totality of the facts in this situation indicate that the taxpayer used reasonable care, caution, and diligence in the filing and remitting of sales and use taxes to the state.

FINDING

Taxpayer's protest is sustained.

CD/KMA/JMM/DK/06/11/07